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The Needs and the Opportunity of the Railroad Situation

By Walker D. Hines

Chairman and General Counsel of
The Atchison, Topeka and Santa Fe Railway Company

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Address delivered at the Fifth Annual Convention of the
Investment Bankers Association of America, at
Cincinnati, Wednesday, October 4, 1916.



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The Needs and the Opportunity of the Railroad Situation

THE railroad companies and the members of your Association have a common interest that railroad securities shall be sound and shall give continued satisfaction to their purchasers. Hence I wish to express my views as to some of the changes which are needed in our laws so as to promote the raising of necessary railroad capital through the issue of securities which will prove sound and satisfactory.

There is now an unusual opportunity to obtain important improvements in the laws which underlie the soundness of railroad securities. So I am going to speak, not of mere abstractions, but of matters which have become severely practical.

The public is giving these things unusual attention and I believe Congress will soon find it appropriate to take decisive action upon them. Therefore I want to ask you to consider certain subjects about which you can give definite assistance, not at some time in the remote future, but in the next few weeks.

Railroad Difficulties a Menace

Public sentiment is unusually alive to these matters because the difficulties of the railroad situation have been accumulating to the point where the country has begun to appreciate with clearness that the public interest will be injured unless those difficulties are removed.

The members of your Association are in an exceptionally good position to perceive the remedies that are necessary and to throw your influence and the influence of your customers in favor of solutions which will promote both public interest and your own.

Bureau of Ry. Securities 11-27-169
Re: Messrs. 4-26-30 A.V.M.
C24 July 18 E.S.

The difficulty which is uppermost in the nation's thought to-day is the defenceless position which the railroad companies and the people themselves occupy with reference to organized railroad labor. Let me mention some of the steps which have led up to this defenceless condition.

Labor Unions and Congress

In June, 1913, the Sundry Civil Appropriation Bill made an appropriation for the enforcement of the Anti-Trust Law which prohibits restraints of trade but provided that no part of the appropriation should be used to prosecute labor unions. This was a striking illustration of the power of the labor unions over Congress, and was an invitation to the labor unions to go as far as they liked.

In July, 1914, the locomotive engineers in the territory west of Chicago and the Mississippi River made demands for increased wages and more favorable working conditions. The railroad companies made counter demands for the modification of various working conditions which they regarded as unreasonably favorable to the engineers.

The railroad companies offered to submit both sets of demands to arbitration under an act of Congress which had been passed the year before with the approval of the Railroad Brotherhoods. The engineers refused to arbitrate the demands made by the railroad companies and said they would strike unless the arbitration was confined to their own demands.

Arbitrary Demands Increase

President Wilson intervened and urged the railroad companies to avert a strike by confining the arbitration to the points which the engineers were willing to arbitrate. The railroad companies, out of deference to the President, yielded to this unreasonable position.

Here the country was face to face with a railroad strike which threatened to tie up transportation throughout the West; the arbitrary position of the Railroad Brotherhood was clearly disclosed; and the support which that position received paved the way for still more arbitrary action in the future.

But despite this impressive warning as to the arbitrary methods of the Brotherhoods and as to the resulting public menace, Congress took no action to protect the public. On the contrary, about two months later legislation was adopted which seemed designed to remove the lid entirely and to give railroad unions and other unions still more power and to make the nation still more defenceless.

Clayton Act and Labor

This legislation was the Clayton Act which was approved by the President on October 15, 1914. Sections 6 and 20 of that Act were inserted by way of compliance with the demands of the labor unions. Section 6 may be construed to provide that the existence and operation of labor unions and the action of their individual members shall not be deemed restraints of trade under the Anti-Trust Act. Section 20 may be construed to provide that strikes shall be regarded as lawful, no matter how unreasonable their purpose or their method.

The prevailing opinion seems to be that these sections deprive the Government of any means whatever to prevent conspiracy to restrain commerce through a railroad strike, no matter how widespread the strike or how unreasonable the motive which actuates the strike.

These were the things which were done in 1913 and 1914 which emphasized and increased the power of the railroad labor unions and encouraged them to their climax of arro-

gance which came last August and which is too fresh in the minds of all of you to justify discussion.

Public Has No Voice

Under the law as it seems to be construed by the Government, the country has no voice whatever in preventing or postponing a railroad strike, no matter how widespread it may be or how arbitrary the leaders of railroad labor may be. The result is that until there shall be some general remedial legislation, the railroads are left in a position which is full of danger to the public and full of discouragement to prospective investors whose capital ought, in the public interest, to be used in the further development and improvement of the railroads.

Since the Government is unable to get the railroad unions to do anything they do not want to do, the whole pressure of the Government is exerted to get the railroads to concede whatever the unions insist upon. When executive pressure fails, then Congress seeks to grant by hurried legislation what the labor unions demand.

If such legislation proves constitutional, the railroads must try to shift the burden to the public, and to do this must get the approval of the Interstate Commerce Commission and to some extent of State Railroad Commissions.

Effect Upon Railroad Securities

The continuance of such a condition is a menace to the soundness of present and future railroad securities, because if railroad revenue is thus put at the mercy of the railroad unions no one can have confidence in the ability of the railroad companies to continue to earn sufficient net income to pay interest, rentals and dividends and to provide the annual surplus necessary to protect railroad credit.

Of course there will be and must be consideration of this

matter by Congress until some method can be found for the settlement of these controversies in a legal and orderly way in accordance with the rights of all parties concerned.

But I wish particularly to emphasize that no such law can be passed except over the opposition of the Railroad Brotherhoods; for they have declared in the most unqualified manner that they will oppose any law which seeks to provide for an official investigation of the merits of a dispute before a strike can take place, and will oppose any other law through which the Government would interfere in any way with the unrestricted freedom of railroad labor to strike whenever it sees fit.

Public Must Find a Remedy

When you consider the past record of Governmental compliance with the wishes of union labor, you will realize that it is not going to be an easy thing to get the necessary remedial legislation when that will be violently opposed by union labor. We must expect the labor unions to use in the future all the political power they can command just as they have done in the past.

Hence your influence and the influence of your customers should be employed to aid in bringing to bear the sentiment of the public generally in favor of a solution which will relieve the public from its present defencelessness and which will give railroad investments the protection of orderly decisions of these matters on their merits.

The time appears almost ripe for Congressional action on other matters of vital importance to the soundness of railroad securities.

I do not need to take up your time in pointing out how the foundations of sound railroad securities have been slowly undermined by the accumulating and conflicting regulations of forty-eight States in addition to the regulations of the Federal Government.

State Action and Net Income

Railroad securities are not issued in fragments according to State boundaries, but are issued as a whole. They depend for their soundness upon the railroad company's present and prospective net income as a whole. Yet that single and indivisible net income is being eaten away by State action—miscellaneous, disjointed, independent and inordinate—through reductions in rates and increases in expenses.

The horizon of each State is circumscribed by its own boundaries and it acts with reference to its own local interests, although nearly all of its railroad regulations have a direct and injurious effect upon the general welfare of each railroad company affected.

The general welfare of each railroad in this country is a matter of national concern, and yet it is affected in countless ways by State authorities who do not and can not look at the matter from a national standpoint.

The dangerous consequences of having a single matter which is primarily of national concern regulated and impaired by forty-eight different States, no one of which has a national horizon or responsibility, are now generally appreciated.

But your help is needed in emphasizing still further the necessity for adequate national action to supersede this destructive patchwork of reductions in rates and increases in costs.

Want Uniform Security Control

Another point with which likewise you are thoroughly familiar is the necessity for uniform and national control over the power to issue and the manner of issuing railroad securities, both stock and bonds.

Under the present State laws the prevailing idea is that a railroad company cannot issue mortgage bonds without obtaining the authority of each State in which any part of the mortgaged railroad lies.

The authorities of each State necessarily deal with the matter according to local conceptions and without any controlling sense of responsibility for the interest of the nation as a whole.

The delays and uncertainties and at times the conflicts incident to these conditions are serious and will become greater as additional States assume the power to control these matters.

State Rule and Stock Issues

When we come to stock issues we find that each railroad company is controlled by the law of the State in which it is incorporated.

One railroad company may have full power to issue additional stock, both preferred and common.

Another may have exhausted its authorized capital and may be without any statutory means of increasing that authority.

Another may have no power to issue preferred stock.

Another may have no power to issue preferred stock without the unanimous consent of the stockholders.

One company may be able to sell its stock at a reasonable market price even though below par, although, generally speaking, stock cannot be sold below par.

Then we have the further complication that frequently a railroad company is incorporated in three or four States, and therefore as to its stock issues is restricted by the laws of each State, and here at times we find absolute deadlocks.

One of the incorporating States may require that new stock shall be offered *pro rata* to existing stockholders and another of the incorporating States may require that stock shall be offered *pro rata* to existing stockholders and existing convertible bondholders.

To add to these difficulties signs are appearing that Railroad Commissions of States which have not incorporated a railroad company are going to insist on regulating its stock issues when its road is partly in those States.

No Adequate Safeguard at Times

Still another difficulty in this respect, from the standpoint of your interests, is that as to some States the law relative to issues of railroad stock and bonds may be exceedingly slight and securities may be issued without adequate safeguard of the interests of investors or of the general public interest. Instances of this sort serve to embarrass the whole situation and to make your customers fearful as to the stability of all railroad securities.

The only solution of these difficulties seems to be Congressional action which will substitute Federal authority and Federal supervision for the present bewildering maze of State authorities and State contradictions. Here your influence will be particularly strong in developing the public sentiment in support of the necessary unified Federal authority and supervision.

Bond Margin of Safety

There is another matter of vast importance which has been frequently touched upon in your annual meetings and with which your members are familiar. That is the proposition that the fundamental soundness of railroad bonds must depend upon the railroad company doing a large part of its financing through the issue of additional capital stock.

Bonds to be sound and attractive must be protected by a wide margin of safety. If seventy-five per cent. of a railroad company's normal annual net income must be used to pay bond interest, it is obvious that a loss of twenty-five per cent. of net income in any year through business depres-

sion or exceptional disaster will bring the company to the brink of insolvency.

But if only forty per cent. of the railroad company's normal annual net income is required for bond interest, it would take a reduction of sixty per cent. in that normal net income to bring its solvency in question. This margin of safety, or the annual surplus of net income over and above fixed charges, is the fundamental element of security and attractiveness in railroad bonds.

Stock Sales Increase Safety

We all know that railroad companies must continue to spend hundreds of millions of dollars for the further improvement and enlargement of their properties. This money must be raised either by the sale of bonds or by the sale of stock. To the extent that this money can be raised by the sale of stock the margin of safety will be increased, because stock entails no obligations for fixed charges.

But to the extent that these hundreds of millions must be raised by the sale of bonds the margin of safety will be impaired, because every time a bond is sold there is an increase in the company's fixed charges.

All you gentlemen know that in recent years conditions have been such that hardly any of the railroad companies in this country could raise new money by the sale of stock. This has been true because with very few exceptions railroad stocks have been sold below par and, generally speaking, no new stock can be sold except at or above par.

Bonds Increase Fixed Charges

Even in cases where railroad stocks have been selling above par the excess over par has been so slight that the offering of a large block of forty or fifty million dollars of new stock would have depressed the price below par.

Under such conditions the railroad companies, almost without exception, have been forced to raise all the money they needed through the sale of bonds. In other words, the railroad industry has had to do nearly all its new business on borrowed money. This has meant the increasing of their fixed charges and consequently the diminishing of their margin of safety.

Every time this margin of safety is reduced through the disproportionate increase of new fixed charges a blow is struck at the attractiveness of that company's bonds, both those now outstanding and those to be issued in the future.

Net Income Basis of Stock Issues

The vital condition for the successful continuance of railroad companies under private ownership is that there shall be a reasonable prospect of earning net income sufficient to make the stock of those companies attractive investments to stockholders.

You gentlemen know that in order for a six per cent. stock to be an attractive investment it is necessary, year in and year out, for the net earnings applicable to dividends to be eight or nine per cent. upon that stock, because the amounts needed to take care of obsolescence and of the creation of new facilities which do not produce revenue are such that it is out of the question for a railroad company to pay out in dividends all the net earnings which are theoretically applicable to dividends.

This question cannot be solved on any theory that railroads can prosper by allowing them a return which is equivalent to ordinary bond interest, because no such return will ever be sufficient to support the issue of capital stock.

No investor is willing to take the risk of investing in capital stock if he is to get no larger return upon it than he could get by investing in well secured bonds.

National Regulation Means Confidence

The establishment of a national method of regulation which will be unified and consistent will be calculated to remove from the railroad situation the present fear that their net income will be regulated down to a basis so low that it will be out of the question for stockholders to look forward with confidence to a continuance of dividends sufficient to make the stock an attractive investment.

Here, too, you gentlemen are in a position of peculiar strength in developing public sentiment. While you and your customers are primarily interested in the sale of bonds, you and they are profoundly interested in there being an adequate basis to secure those bonds.

You know, and you can make it clear to them, that that basis cannot exist unless railroad net income is sufficient to enable railroad companies to do a large part of their new financing through the issue of stock and unless the laws are so simplified and unified as to admit of the issue of stock under appropriate national supervision.

What Railroads and Public Need

To recapitulate: The railroads need, and you need, and the public needs, first, legislation which will provide an orderly and responsible method of settling railroad labor disputes as a substitute for the terrorism of the strike; second, legislation whereby State regulations reducing net income through reductions of rates and increase of costs will be superseded by national regulation; and third, legislation whereby the power to issue stocks and bonds will be derived from the nation, and the method of their issue will be supervised by the nation.

And all these things are needed to the end that railroads may raise their new capital largely through the sales of stock so as to give them a broad and sound financial basis which